16 September 2019 /// n°30-2019

ECB on the verge of a nervous breakdown

Key Points

- **New asset purchases draw criticism from policymakers**
- **Bank stocks up on tiering relief**
- **US and German yields rebound**
- **Stock indices near year highs**

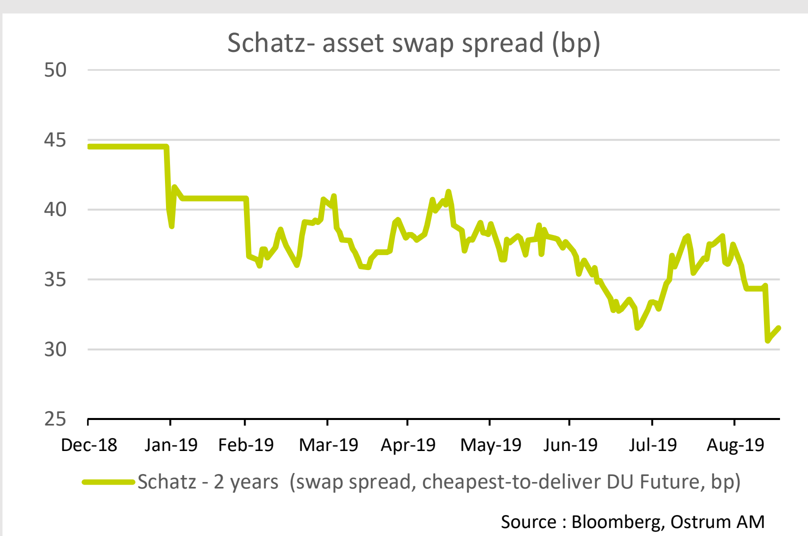
The ECB's decision validated the recent rebound in equity markets. European and US market indices are trading close to 2019 highs. European bank stocks got a boost from a new reserve tiering mechanism. The fall back in the yen provide relief to Japan's Nikkei in high volumes ahead of a long weekend. Yet the sharp rise in oil prices after the attack on Saudi Aramco's facilities did spark some profit-taking early on Monday.

Bond yields rebounded strongly in the US in part due to higher core CPI inflation. The yield on 10-year notes (1.84%) hit a weekly high at 1.90%. Gilts are caught in the bond correction despite ongoing political turmoil.

In the euro area, several policymakers made clear that they opposed the resumption of net asset purchases. This may explain part of the Bund selloff above -0.50%. Sovereign and credit spreads have tightened. High yield spreads have narrowed by more than 20bp over the past week.

In currency markets, there was not a clear trend on the US dollar. The euro traded as high as $1.11 whilst the Japanese yen weakened to about 108. Gold is stable just over the $1500 mark.

Chart of the week



Reserve tiering will generate liquidity arbitrages by banks. Zero interest rate will apply to a multiple of reserve requirements (6x) whilst the deposit rate set at -0.50% will prevail beyond this threshold.

Liquidity hoarding will now be less penalizing for banks, so that repo rates may creep higher. This is one of the reasons why Schatz have underperformed swaps (indexed to interbank rates). Bank savings accounts (term deposits) could be favored now to the detriment of money market funds.

ECB will adjust the multiple to keep money rates anchored to the deposit rate floor.

The end of the Draghi era

Monetary easing measures decided last Thursday marked the end of an era at the European Central Bank. Mario Draghi cut interest rates, announced the implementation of a reserve tiering mechanism and relaunched asset purchases. That said, this decision drew considerable criticism from policymakers. Klaas Knot, Jens Weidmann and even Benoit Coeuré judged that new asset purchases were not justified at this juncture. In this context, Christine Lagarde's first task will be to re-establish consensus within the Governing Council.

Reserve tiering was much anticipated. Banks will be able to deposit the equivalent of 6 times their reserve requirement with the ECB at an interest rate of 0%. Excess liquidity holdings will be subject to the deposit rate which was brought down to -0.50%. Given excess liquidity of $1800b in the euro area, the deposit facility rate represented a tax of bank worth €7.2b a year. This measure will help raise bank margins but its effect on short-term rates is uncertain. Liquidity hoarding will be less costly and one can assume that bank liquidity demand may result in higher repo rates and lower swap spreads. Money market funds may face competition from term deposits issued by commercial banks. The ECB will adjust the multiple if money market rates drift away from their main policy rate, which is the deposit rate in current circumstances.

In turn, forward guidance has evolved. The interest rate policy is now linked to the behaviour of headline and underlying inflation relative to the 2% goal. However, core inflation has been under the 2% objective since 2002. New asset purchases will amount to €20b a month from November 1st and may continue until ECB rates start to rise. The fact that QE is open-ended whilst no security-level holdings limits are unchanged raise doubt about an asset purchase programme rejected by several policymakers.

Markets digesting easing measures before the FOMC

The rebound in Bund yields above -0.50% is traceable to position unwinding and repo market adjustments. Sovereign debt spreads have come in with higher-beta BTPs outperforming (132bp on 10-year bonds).

Credit benefitted a risk-on trend across risky asset markets with significant outperformance from the high yield segment. Indeed, euro IG spreads declined by 3bp to 108bp vs. Bunds. High yield tightened by 22bp to 340bp over German debt. Reserve tiering sparked bank bond buying.

In equity markets, bank stocks have logically outperformed ending the week up 3.3% beating the market by fully 2pp. Undervalued cyclical stocks rose on signs of de-escalation in the US-China trade conflict. Hope is supporting markets although Donald Trump still has to make a decision on European auto tariffs and the luxury sector now appears to be a target. With equity market indices near year highs, market participants may seek other investment themes. The pickup in bank stocks and cyclical value stocks echo profit-taking among the defensive-growth group, which have thrived as cyclical indicators signalled slower growth.

Another mandatory Fed cut

The Fed will go ahead with another 25bp rate cut this week in a bid to shelter the US economy from global uncertainty. Tensions in the middle-East, Brexit anxiety and the Hong Kong crisis will justify additional insurance. The reality is that the Fed policy is dictated by financial markets. Jerome Powell, under pressure from Donald Trump, cannot assume triggering a market correction to comply with the dual mandate of price stability and sustainable employment. The upturn in core inflation (2.4%y in August) and the worrying consumer credit increase will hence be largely ignored. There are more urgent matters. Demand for Treasuries has weakened over the past few months leaving primary dealers with large exposure to US government bonds (particularly short-term bonds). The resumption of net Treasury bond purchases hence responded to growing concerns regarding the US federal deficit. The budget shortfall will top $1T this year. Thus, despite opposition from Esther George and Eric Rosengren, the Fed will cut interest rates. Diverging views will show up in the dot chart representing participants' individual rate outlook.

The US bond market rout stems from asset allocation flows, concerns about the US federal deficit and possibly higher inflation. The rise in crude oil prices after the attacks on Saudi Aramco's facilities has mitigated the UST bond selloff despite the likely impact of dearer oil on inflation. Key technical levels on the upside hover about 1.86% with the next target at 2.01% whilst a break below 1.76% could lead to further decline towards previous lows.

Breakeven levels derived from TIPS have increased by some 10bp about half the rise in nominal bond yields. US corporate credit markets have not moved a lot in response to the sharp rebound in bond yields. Emerging bond markets have weathered higher US yield volatility. The spread on emerging bonds shrank and now stands just 6bp above the 2019 tights at 326bp. US equity markets is trading close to record highs despite the expected earnings recession in the third quarter.

Main Market Indicators

G4 Government Bonds	16-Sep-19	-1wk (bp)	-1m (bp)	Ytd (bp)
EUR Bunds 2y	-0.73 %	+13	+19	-12
EUR Bunds 10y	-0.48%	+11	+21	-72
EUR Bunds 2s10s	25 bp	-3	+2	-61
USD Treasuries 2y	1.76 %	+17	+29	-73
USD Treasuries 10y	1.84 %	+19	+28	-85
USD Treasuries 2s10s	7 bp	+2	0	-12
GBP Gilt 10y	0.69 %	+10	+23	-58
JPY JGB 10y	-0.15 %	+10	+8	-16
€ Sovereign Spreads (10y)	**16-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
France	28 bp	-2	+1	-19
Italy	132 bp	-21	-76	-118
Spain	74 bp	-7	-3	-44
Inflation Break-evens (10y)	**16-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR OATi	80 bp	+5	+4	-
USD TIPS	168 bp	+10	+13	-3
GBP Gilt Index-Linked	341 bp	-1	+0	+23
EUR Credit Indices	**16-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
EUR Corporate Credit OAS	108 bp	-3	-1	-44
EUR Agencies OAS	48 bp	-2	-3	-12
EUR Securitized - Covered OAS	43 bp	-2	-3	-20
EUR Pan-European High Yield OAS	340 bp	-22	-65	-173
EUR/USD CDS Indices 5y	**16-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
iTraxx IG	47 bp	-1	-7	-42
iTraxx Crossover	243 bp	+4	-37	-110
CDX IG	51 bp	-1	-8	-37
CDX High Yield	316 bp	-12	-43	-135
Emerging Markets	**16-Sep-19**	**-1wk (bp)**	**-1m (bp)**	**Ytd (bp)**
JPM EMBI Global Div. Spread	327 bp	-12	-34	-88
Currencies	**16-Sep-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
EUR/USD	$1.100	-0.38	-0.86	-3.96
GBP/USD	$1.242	+0.62	+2.34	-2.55
USD/JPY	¥108.03	-0.53	-1.38	+1.51
Commodity Futures	**16-Sep-19**	**-1wk ($)**	**-1m ($)**	**Ytd ($)**
Crude Brent	$69.2	$6.6	$11.0	$14.1
Gold	$1 503.3	$12.0	$1.4	$221.7
Equity Market Indices	**16-Sep-19**	**-1wk (%)**	**-1m (%)**	**Ytd (%)**
S&P 500	2 997	0.61	3.73	19.54
EuroStoxx 50	3 518	0.67	5.69	17.23
CAC 40	5 602	0.24	5.69	18.42
Nikkei 225	21 988	3.72	7.69	9.86
Shanghai Composite	3 031	1.04	7.33	21.53
VIX - Implied Volatility Index	14.77	-3.27	-20.03	-41.90

Source: Bloomberg, Ostrum Asset Management

Writing

AXEL BOTTE
STRATEGIST
axel.botte@ostrum.com

Legal information

www.ostrum.com

Ostrum Asset Management
Asset management company regulated by AMF under n° GP-18000014 – Limited company with a share capital of 27 772 359 euros
Trade register n°525 192 753 Paris – VAT: FR 93 525 192 753 – Registered Office: 43, avenue Pierre Mendès-France, 75013 Paris – www.ostrum.com
Tél. : 01 58 19 09 80

Ostrum
ASSET MANAGEMENT

Un affilié de NATIXIS
INVESTMENT MANAGERS